Supreme Court, U.S.
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90-1389

No. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

CLARK EQUIPMENT COMPANY, and consolidated subsidiaries,

Petitioner,

— v. —

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES
CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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Questions Presented For Review

1. Whether, in interpreting a federal tax statute which bars tax deduction of premiums paid to repurchase convertible debentures, the Sixth Circuit Court of Appeals may determine, without regard to the lack of equity being issued, that all losses arising from the conversion are nondeductible costs of issuing the taxpayer's equity?

2. Whether, in a case of first impression in interpreting a federal tax statute, the Sixth Circuit Court of Appeals may uphold the disallowance of tax deductions for the costs of borrowing money when the Second and Seventh Circuit Courts of Appeals have each indicated Congress did not have an intention to disallow the costs of borrowing money when enacting the statute under review?

3. Whether, in a case of first imperssion in interpreting a federal tax statute, the Sixth Circuit Court of Appeals may uphold a decision of the District Court disallowing tax deductions for the costs of borrowing money when both the District Court and the Court of Appeals agree in their opinions that Congress had no intention to disallow the costs of borrowing money when enacting the statute under review?

PARTIES TO THE PROCEEDING BELOW

Clark Equipment Company, together with each of its wholly owned and tax consolidated U.S. domestic subsidiaries, including Clark Equipment Overseas Finance Corporation, were the Plaintiff-Appellant before the United States Court of Appeals for the Sixth Circuit. The United States of America was the Defendant-Appellee.

Clark Equipment Company makes the following disclosure:

1. Clark Equipment Company has no parent corporation.

2. Other than wholly owned subsidiaries, Clark Equipment Company has the following subsidiaries.

Subsidiary	*Percentage Controlled*
Hurth Axle S.p.A.	83%
Hurth Axle France S.A.R.L.	83%
Hurth Axle Valsugana S.p.A.	84%
Hurth Axle North America, Inc.	86%

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IN THE

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CLARK EQUIPMENT COMPANY, and consolidated subsidiaries,
Petitioner,

— v. —

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

Opinions Below

The final (per curiam) opinion of the United States Court of Appeals for the Sixth Circuit, denying Plaintiff-Appellant's petition for rehearing, appears in the appendix to this petition (App. pp.1a), as well as the initial opinion of the Court of Appeals (per Ryan, J.) (App.2a-12a). Also appearing in the appendix is the decision and order of the United States District Court for the Western District of Michigan (Elsen, D.J.) (App. 13a-20a).

On 17 December 1990, an order of this Court was issued ordering that the time for filing a petition for a writ of certiorari in this case be extended to and including March 4, 1991.

The initial opinion of the Court of Appeals is reported at 899 F.2d 1298 (6th Cir. 1990). The final opinion of the Court of Appeals has not been reported. The decision of the District Court has not been reported.

Jurisdiction

On October 3, 1990 the United States Court of Appeals for the Sixth Circuit denied petitioner's petition for rehearing of its August 22, 1990 judgment. The jurisdiction of the Court is invoked pursuant to 28 U.S.C. Paragraph 1245(1) (1986).

Statute Involved in the Case

Internal Revenue Code Section 249, 26 U.S.C. § 249, appears in the appendix to this petition (App. 21a).

Statement of the Case

In 1966, Clark Equipment Company ("Clark") established a wholly-owned subsidiary, Clark Equipment Overseas Finance Corporation ("CLEO"). In 1966, CLEO issued fifteen million dollars of debentures in $1,000 denominations. After a two for one split in Clark stock the debentures became convertible — at the option of the debenture holder — into Clark stock at an exchange rate of $39 of principal amount per share.

In 1973, the holders of debentures with an aggregate face value of $1,447,000 exercised their options with CLEO to convert their debentures at a rate of 25.641025 shares of Clark stock per $1,000 debenture, with cash for for fractional shares of Clark stock at the current market value of the Clark stock at the date of each conversion. In exchange, CLEO provided the debenture holders with Clark stock which it had purchased from Clark (and cash in lieu of fractional shares) in which CLEO had a tax basis (cost) of $1,839,989. Upon receipt of the debentures by CLEO, they were cancelled. CLEO did not issue its capital stock in connection with these conversion transactions. CLEO claimed a tax deduction for its losses of $392,989 incurred by reason of the conversions. CLEO claimed the losses as a cost of borrowing money. CLEO's deduction was denied by the United States.

CLEO paid the tax assessed by the United States and filed a claim for refund of that tax. CLEO's refund claim was denied by the United States and CLEO brought action to enforce that refund claim in the United States District Court for the Western District of Michigan.

In a case of first impression in interpretation of a federal tax statute, the District Court held CLEO was not entitled to its refund by reason of Internal Revenue Code Section 249. Section 249 bars tax deductions for premiums paid when repurchasing convertible debt.

By repurchasing convertible debt, conversions can be avoided. While premium is usually paid in repurchases to avoid conversions, a taxpayer's cost of issuing its own equity is not a tax deductible cost. Prior to Section 249, a tax deduction for premium paid could be achieved when repurchasing convertible debt to avoid conversions into the taxpayer's equity. Section 249 had, therefore, been enacted by Congress to bar tax deductions for premium paid on repurchases by a taxpayer of its convertible debt in attempts to avoid issuing its equity in a tax neutral conversion transaction.

CLEO had not been involved, however, in attempting to avoid conversions or in trying to avoid issuing its equity. Indeed, it was losses having nothing to do with its equity which CLEO had incurred. CLEO had also incurred its losses because of the conversions, not in attempts to avoid them.

Although CLEO had not claimed a tax deduction for premium paid upon repurchasing convertible debentures, and although all prior commentary had been to the effect a taxpayer could properly claim a tax deduction for losses incurred upon conversion of its debentures into the shares of its parent, the Distric Court, never the less, held a conversion transaction to be a repurchase by a debtor of its debt within the meaning of Section 249.[1] Although CLEO had also claimed losses on its conversions, rather than deductions for premium paid to repurchase its debt to avoid issuing its equity, the District Court, never the less, held CLEO'S claim of tax losses to be claims it had paid premiums to retire its convertible debt within the meaning of Section 249.

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[1] Fox, *Financing Foreign Operations Through Domestic Finance Subsidiaries*, 55 Va. L. Rev. 1036 (1969); Committee on Taxation of International Finance and Investment, Tax Section, New York State Bar Association, *Report on International Finance Subsidiaries*, 28 Tax L. Rev. 439

In explanation of its expanded interpretation of Section 249 to cover conversion transactions, the District Court cited *National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982), wherein a taxpayer had been involved with issuing its own equity in capital transactions in its own shares. The District Court in quoting *National Can* stated the limitations of Section 249 were intended to apply to costs associated with "capital transactions" where taxpayers are involved with issuing their own capital stock, rather than with borrowing money. The District Court quoted *National Can* to the effect Congress had consistently drawn a line between bond premiums attributable to the interest cost of borrowing money and bond premium attributable to a conversion privilege. The District Court then quoted *National Can* to the effect Congress had reasoned in passing Section 249 that premium due to a conversion feature is not analogous to an interest expense, but rather is similar to an amount paid in a capital transaction.

The District Court had erred, however, in applying the rule of *National Can* to CLEO and the District Court had erred twice. The District Court had first erred by expanding Section 249 beyond its normal linguistic meaning in an effort to correct an evil which it perceived Congress had intended to correct. More importantly, however, the District Court had erred in doing so where the evil was not present. The District Court had mistakenly applied the rule to a taxpayer which was not issuing its equity.

CLEO had not been involved with issuing its equity. CLEO had been borrowing money. In fact, all of CLEO's costs had been costs of borrowing money, rather than the costs of issuing equity. The District Court in a case of first impression had disallowed the costs of borrowing money by a taxpayer and had done so where Congress had never expressed such an intent. In doing so, the District Court had also strained the meaning of the tax statutes far beyond their original intent.

CLEO appealed the decision of the United States District Court to the Circuit Court of Appeals for the Sixth Circuit. CLEO asserted the District Court had erred since all of CLEO's costs sought to be deducted were borrowing costs and

CLEO had not been involved in capital transactions or the issuance of its equity. CLEO argued in the Court of Appeals that the well supported law of the Seventh Circuit cited by the District Court to the effect Section 249 applied only to capital transactions and issuance of a taxpayer's equity should permit CLEO, which had not been involved in capital transactions or issuance of its equity, a current tax deduction for its costs of borrowing.

The Sixth Circuit, noting the language of Section 249 nowhere mentioned "capital transactions", held that one crucial test of Section 249 was whether the costs sought to be deducted were costs of borrowing, as versus costs of conversions, and drew a line of mutual exclusivity between the two. For the first time in U.S. tax law and in contravention to all prior rulings of the Internal Revenue Service, the Sixth Circuit held costs associated with the conversions of convertible debt instruments not to be tax deductible costs. See Revenue Ruling 69-135, 1969-1 C.B. 198.

The Sixth Circuit had held all costs of conversions not to be costs of borrowing and had, therefore, held CLEO's costs not to be tax deductible because CLEO's borrowing costs arose from conversion transactions. As authority for conversion transactions not being tax deductible, the Sixth Circuit cited *National Can*, *supra* and *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300 (2nd Cir. 1971), where the taxpayers had been involved with issuing their own equity. National Can had been issuing its equity in exchange for the convertible debentures of its subsidiary, while Chock Full O'Nuts had attempted to deduct discount associated with the privilege of converting debt into its own equity. Both corporations, unlike CLEO, were engaged in capital transactions, in issuance of their own equity. They were each attempting to deduct the costs of their own equity associated with a conversion privilege into their own shares.

Unlike CLEO, the taxpayers in *National Can* and *Chock Full O'Nuts* had been engaged in capital transactions and, therefore, were not attempting to deduct borrowing costs. In the factual analysis of *National Can* and *Chock Full O' Nuts*, the

costs of those capital transactions had been correctly characterized by the Seventh and Second Circuits as "costs of the conversions", rather than the "costs of borrowing" and, therefore, not tax deductible cost. The Sixth Circuit then expanded this analysis, however, to decide that no conversion costs were tax deductible, even when the conversion costs arose as a cost of borrowing and were not related to the taxpayer's issuance of equity.

In its review, the Sixth Circuit had erroneously applied the facts of *National Can* and *Chock Full O'Nuts* instead of the law of those cases and had analogized that all conversion costs were different from borrowing costs. The Sixth Circuit then held CLEO's borrowing costs were costs of issuing CLEO's equity.[2]

Lest there be any mistake as to whether the Sixth Circuit determined CLEO's interest expenses were not interest expenses, the Sixth Circuit stated:

> Appellant also claims, *inter alia*, that section 249 cannot apply in this case because no 'repurchase' occurred and the costs of conversion were attributable to 'costs of borrowing.' We conclude that no statutory or case law supports appellant's arguments.

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[2] The Sixth Circuit in footnote 2 to its opinion quoted the legislative history of Section 249 where a repurchase of a convertible debenture to avoid a capital issuance by a taxpayer was described in the House Report as "similar" to a capital transaction. The Sixth Circuit then made the error of assuming CLEO's conversions of pure debt instruments were "similar" to capital transactions when no equity issue was intended by CLEO or even possible under the factual pattern undertaken by CLEO or the circumstances under review. The Sixth Circuit then continued its analysis of the House Report as to permiums paid by those taxpayers who had sought to avoid issuing equity and whose tax deductions Congress had sought to bar. The cost of those taxpayers were described by the Sixth Circuit as 'not analogous to an interest expense or deductible business expense, but rather is similar to an amount paid in a capital transaction.' The Sixth Circuit then erroneously found CLEO'S costs of borrowing money through a convertible debt instruments to be "similar" to the costs of issuing equity, even though CLEO had converted straight debt and had not been involved with issuing equity.

As to whether CLEO's costs were costs of borrowing, the cost of borrowing has most often been described as interest. In *Deputy v. DuPont*, 308 US 488; 60 S.Ct. 363, this Court held interest to be compensation paid for the use or forbearance of money, a charge for the loan of money or for the delay in payment of money.

It is evident from these uncontested facts that CLEO loaned its creditors $1,447,000 and was required to deliver to those same creditors property and cash for which CLEO had paid $1,838,189. Because CLEO was not involved with these creditors in issuing its equity to them or in any other activity with them, other than loaning funds to them, it should be obvious CLEO incurred $391,189 of interest expense from the transactions at issue. There is no question of fact or law. CLEO's costs were clearly costs of borrowing.

As to whether the exchange by CLEO of its convertible debt for the shares of Clark is a taxable event for CLEO and its debtors or a tax free issue of stock, in Revenue Ruling 69-135, 1969 1-C.B. 198, it was held the exchange of bonds of one corporation for common stock of another pursuant to the bond's exchange privilege was a taxable event on which gain or loss is recognized. In Revenue Ruling 69-135 the outstanding bonds of X Corporation were converted by the holder into stock of Y Corporation: X and Y were "separate and distinct corporations." The Service concluded that "Since the bonds and the stock in this case were issued by two separate and distinct corporations... gain or loss is recognized on the exchange of the bonds of X for common stock of Y to the extent of the difference between the fair market value of the common stock of Y received and the cost or other basis of the bonds of X exchanged therefore."

Reasons for Granting the Writ

The Sixth Circuit has now held all losses arising upon the conversion of debt instruments, even costs of borrowing money where no equity is being issued, to no longer be tax deductible. This is an important question of federal law which has not been, but should be settled by this Court.

The Sixth Circuit so held because CLEO's borrowing costs had arisen from conversion transactions and the Sixth Circuit applied the facts, rather than the law, of *National Can* and *Chock Full O'Nuts, supra*. The Sixth Circuit now holds all conversions of convertible debentures are the conversion of debt into equity, even when, as here, the convertible debentures are not convertible into the taxpayer's equity.

The decision of the Sixth Circuit is the first instance where a Circuit Court of Appeals has denied the tax deduction of borrowing costs or interest expense by holding them not to be borrowing costs or interest expense. This decision will have far reaching effect in all areas of interpretation of federal law as to the meaning and tax deductibility of interest expense, convertible debentures and borrowing costs.

The Sixth Circuit in asserting the test of Section 249 to be whether a taxpayer has been involved with conversion transactions, has both erred as to this decision and has ruled in conflict with the well supported law of the Seventh Circuit cited by both the District Court below and by the Sixth Circuit itself. *National Can, supra*. The Sixth Circuit has also shredded the basic fabric of the tax law as to the tax deduction of interest expense or borrowing costs arising from transactions in convertible debentures. That basic tenet of tax law is that borrowing costs are tax deductible costs, whereas costs of issuing equity are not. The proper test of law, as cited by the Seventh Circuit in *National Can* and by the District Court is whether or not the taxpayer's costs arise from borrowing money or, in the alternative, whether those costs arise from the issuance of the taxpayer's equity, not whether those costs arise from conversion transactions.

A new rule of tax law should not be allowed to arise which bars the tax deduction of borrowing costs simply because those costs arise from payment in property at the option of the debtor, rather than from payment in cash. If property, rather than cash, is delivered as a cost of borrowing money, there should be no bar for that reason to a deduction of the costs of the borrowing. There is no evidence Congress intended such a bar.

It is also very clear that the Seventh Circuit and the Second Circuit have drawn the line of tax deduction between borrowing costs and the costs of issuing equity, rather than having drawn the line of tax deduction at whether or not costs arise from convertible debt instruments as versus costs arising from straight debt. Congress has drawn the line at the same place. This application of the law in the Sixth Circuit is in conflict with the decisions of both the Seventh Circuit as evidenced by *National Can* and the Second Circuit as evidenced by *Chock Full O'Nuts*.

This is a case of first impression in the interpretation of a federal tax statute by the Sixth Circuit. The interpretation made is so divergent from the cases and reasoning of Congress cited by the Sixth Circuit and the District Court below as to be a departure from the accepted and usual course of judicial proceedings. Such a divergence from accepted and usual course of judicial proceedings calls for this Court's exercise of its power of supervision.

Conclusion

The Sixth Circuit must be overruled. The federal tax law needs to be interpreted both with logic and consistency in every Circuit. The tax law should permit the deduction of borrowing costs as Congress intended, and in every Circuit. This includes borrowing costs arising from losses on conversions when there is no issuance of the taxpayer's equity. For the reasons set forth above, petitioner urges that this petition for a writ of certiorari be granted.

Respectfully Submitted,

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Dated: March 4, 1991

APPENDIX

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No. 89-1926

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

ORDER

CLARK EQUIPMENT COMPANY, and consolidated subsidiaries

Plaintiff - Appellant

v.

UNITED STATES OF AMERICA

Defendant - Appellee

BEFORE: GUY and RYAN, Circuit Judges, and ENGEL, Senior Circuit Judge

Upon consideration of the appellant's motions for supplemental briefing, reargument, and to file a petition for rehearing out of time,

It is **ORDERED** that the motions for supplemental briefing and reargument be, and they hereby are, denied. The motion to file a petition for rehearing out of time is granted.

Furthermore, upon consideration of the petition for rehearing, It is **ORDERED** that the petition be, and it hereby is, denied.

ENTERED BY ORDER OF THE COURT
Leonard Green, Clerk

Dated: October 3, 1990

No. 89-1926

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

CLARK EQUIPMENT COMPANY, and consolidated subsidiaries,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

ON APPEAL from the United States District Court for the Western District of Michigan.

Decided and Filed August 22, 1990

Before: GUY and RYAN, Circuit Judges; and ENGEL, Senior Circuit Judge.

RYAN, Circuit Judge. Plaintiff-appellant, Clark Equipment Company and its subsidiaries, appeals the district court's judgment in favor of defendant in this federal income tax case. The appeal presents the following issues:

1. Whether the district court erred in holding that 26 U.S.C. § 249 prohibited plaintiff's claimed deduction concerning the conversion of CLEO debentures into Clark stock.

2. Whether the district court erred in holding that 26 U.S.C. § 249 applied to the transactions in

this case, given the effective date provision of the statute.

We conclude that the district court correctly held that appellant was not entitled to the claimed deduction concerning the conversion of debentures. Section 249 applies to the transactions and bars the deduction. Thus, we affirm the judgment of the district court.

I.

This case was submitted to the district court upon stipulated facts. Clark Equipment Overseas Finance Corporation ("CLEO"), a wholly-owned subsidiary of Clark Equipment Company ("Clark"), issued $15 million of debentures in $1,000 denominations on March 1, 1966. The debentures offered holders the option, from August 1, 1967 to February 29, 1976, to convert the debentures into shares of Clark common stock at a specified conversion rate. The original indenture provided that Clark would effect the conversions. On July 14, 1971, the indenture was amended to provide that CLEO would effect the conversions.

In 1973, the tax year in question, Clark and CLEO filed a consolidated federal income tax return. During that year, holders of debentures with an aggregate face value of $1,447,000 converted their debentures into Clark common stock and cash.[1] CLEO obtained the Clark stock from Clark in order to complete the conversions. The cost of the stock and cash paid to holders of debentures converted in 1973 totaled $1,839,989. On the 1973 tax return, CLEO claimed a deduction of $392,989, the amount by which the cost of conversion exceeded the face amount of the converted debentures, as an ordinary business expense.

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[1]Debenture holders converting their debentures received cash in lieu of fractional shares of Clark common stock.

The Internal Revenue Service disallowed the deduction and, after Clark and its subsidiaries paid the tax deficiency, disallowed the refund claim. Appellant brought suit against the government under 28 U.S.C. § 1346(a)(1) to recover the taxes and interest paid.

On July 14, 1989, the district court filed an opinion concluding that CLEO was not entitled to the claimed tax deduction. The court held that the "relevant exchange in this case . . . is essentially a capital transaction" and that 26 U.S.C. § 249 applied to prohibit the deduction concerning the conversion of the debentures. This appeal followed issuance of the district court's judgment order.

II.

Appellant argues that 26 U.S.C. § 249 does not bar CLEO's claimed deduction for the "loss" incurred on the conversion of the debentures for two reasons: 1) the provisions of section 249 do not apply to the subject transactions; and 2) even if section 249 does apply to such transactions, it would not bar CLEO's deduction because of the effective date provision of the statute. We address each claim in turn.

A. *Application of 26 U.S.C. § 249*

Section 249 disallows deductions of certain amounts associated with the repurchase of convertible debentures.

> No deduction shall be allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note, or certificate or other evidence of indebtedness which is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness which are not convertible.

> The preceding sentence shall not apply to the extent that the corporation can demonstrate to the satisfaction of the Secretary that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature.

26 U.S.C. § 249(a).

Appellant argues that the district court erred in finding that section 249 precludes appellant's claimed deduction because that section does not apply to the transactions in question. That is so, appellant claims, because section 249 applies only to capital transactions or to taxpayers attempting to avoid capital transactions, and the transactions in question here are neither.[2] Appellant also claims, *inter alia*, that section 249 cannot apply in this case because no "repurchase" occurred and the costs of conversion were attributable to "costs of borrowing." We conclude that no statutory or case law supports appellant's arguments.

The language of section 249 identifies five elements that must be present as a condition of the applicability of the statute to transactions of the kind involved in this case:

1) The *issuing corporation* is attempting to claim the deduction;

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[2]Appellant focuses its argument on this "capital transaction" theory, but we note that section 249 nowhere mentions "capital transactions." It is the statutory language, of course, which governs our construction.

The legislative history, however, refutes appellant's argument by indicating that section 249 was intended to govern these repurchases which are "similar" to capital transactions. "[T]he amount of the premium which is in excess of the cost of borrowing is not analogous to an interest expense or deductible business expense, but rather is similar to an amount paid in a capital transaction." H.R. Rep. No. 413, 91st Cong., 1st Sess. 111, *reprinted in* 1969 U.S. Code Cong. & Admin. News 1645, 1759.

2) that corporation *paid or incurred a premium* in the conversion transactions;

3) that corporation *repurchased* debentures;

4) the debentures were *convertible into the stock of a corporation in control of the issuing corporation;* and

5) the amount disallowed as a deduction is *attributable to the conversion feature.*

All five elements are present in this case. The first of the five, the "issuing corporation" requirement, is clearly met. CLEO issued the debentures and CLEO claimed the deduction. The fourth requirement, convertibility, is also fulfilled. CLEO issued debentures convertible into Clark common stock and CLEO, a wholly-owned subsidiary of Clark, is under the control of Clark.[3] We discuss the remaining three requirements in greater detail below.

1) *Premium Paid or Incurred*

Appellant argues that the second of the listed requirements for the application of section 249, that the issuing corporation paid or incurred a premium, is not met in this case because, "[u]nder the plain meaning of the word premium, CLEO paid no premium. CLEO delivered only what was required of CLEO under the terms of the debentures." Appellant claims, without legal support, that "[a] premium on the acquisition of a bond or debenture only arises when an additional sum or value is paid over that promised in the instrument."[4] We disagree.

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[3]*See* 26 U.S.C. §§ 249(a)(2) and 368(c).

[4]Appellant attempts to support its argument by analogizing the amount paid in these conversions to the $1,000 that would have been paid to redeem the debentures at maturity, both amounts given in the terms of the debentures. Appellant claims that "[i]n any situation with

The applicable regulations define "repurchase premium" as "the excess of the repurchase price paid or incurred to repurchase the obligation over its 'adjusted issue price.' " 26 C.F.R. § 1.249-1(c)(1). The key figure is not, as appellant claims, the amount given in the conversion terms of the debenture, but rather is the "adjusted issue price" or, in this case, the face amount of the debenture. *See* 26 C.F.R. § 1.249-1(c)(2).

Appellant paid $1,839,989, in Clark stock and cash, to repurchase converted debentures with a total face amount of $1,447,000. The excess of the first figure over the second, the "repurchase premium" as defined in the regulations, is the amount appellant has claimed as a deductible loss. Contrary to appellant's arguments, that figure, $392,989, represents the "premium paid" as that term is used in section 249.

2) *"Repurchase" of Debentures*

Appellant argues that the third requirement as we have listed them, that the issuing corporation repurchased the debentures, is unmet because the conversions in this case did not involve a "repurchase." Appellant claims that "merger and cancellation [of debt instruments] must be held to be an essential element of any definition of repurchase" and that a "repurchase" requires an exchange for cash. The district court disagreed, noting that "[t]he word 'repurchase' is used

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alternative means of redemption, any one chosen method of redemption—here conversion—does not create a premium when compared with the other method." Appellant's analogy compares apples with oranges since alternative means of redemption are not involved here. A conversion differs from a redemption. As the Second Circuit has stated, "[t]he convertible debenture is an indivisible unit; the issuer has but one obligation to meet, either redemption *or* conversion. It can never be required to do both." *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 305 (2d Cir. 1971). We are not convinced by appellant's attempt to bolster its own definition of "premium."

broadly to cover the rendering of money or, as is a common method of disposal, the conversion of the bond or debenture into stock."

We too disagree with appellant's understanding of the meaning of the term "repurchase" in section 249. "The most basic tenet of statutory construction holds that courts are required, where possible, to give words their plain, unambiguous meaning." *Lynch v. Lyng*, 872 F.2d 718, 720-21 (6th Cir. 1989). The Supreme Court recently relied upon a dictionary definition when determining the common meaning of a statutory term,[5] and we find the dictionary helpful in this situation as well. "Repurchase" means to "regain by purchase" and "purchase" means "to acquire by the payment of money or its equivalent." Random House Dictionary of the English Language 1166, 1218 (1981).

In this case, CLEO issued the convertible debentures and then CLEO effected the conversions by paying money or its equivalent, shares of Clark stock, to the debenture holders to acquire the debentures. We hold that the plain meaning of the term "repurchase" includes those transactions by CLEO.

3) *Amount Attributable to Conversion Feature*

The fifth element of section 249, as we have listed them, is that the disallowance of a deduction for a premium paid on the repurchase of convertible debentures does not apply "to the extent that the corporation can demonstrate to the satisfaction of the Secretary that such excess *is attributable to the cost of borrowing and is not attributable to the conversion feature.*" 26 U.S.C. § 249(a) (emphasis added). Thus, for section 249 to bar CLEO's deduction, the premium must be attributable to the conversion feature of the debentures.

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[5] *See Mallard v. United States Dist. Court*, 109 S. Ct. 1814, 1818 (1989).

Appellant argues that the amount CLEO claimed as a deduction is attributable to the cost of borrowing and, therefore, the deduction is not prohibited by section 249. According to appellant, "the key is always whether or not the taxpayer is issuing its equity. If the taxpayer is not issuing its equity, all costs associated with bonds or debentures are costs of borrowing. . . . [C]onversion costs are the costs of borrowing when the conversion is into the equity of another party." We think appellant's unsupported statements contradict established legal principles.

The Second Circuit, in a case examining amortized bond discount, differentiated costs of borrowing from amounts attributable to the conversion feature of convertible debentures.

> [T]he taxpayer has failed to satisfy its burden of showing that the amount of the issue price allocable to the conversion feature represents a cost of borrowing money that must without qualification be paid. Its inability to meet this condition arises from the fact that the debentures provide for two mutually exclusive modes of satisfaction. Under one the holder may exercise his right to convert the debenture into common stock, in which event he will surrender his debenture and it will not be redeemed or paid at maturity. To permit deduction of the amount attributable to the conversion feature in the face of such a possibility would be to disregard established conditions precedent to the allowance of discount as a cost of borrowing money which must be repaid.

Chock Full O'Nuts Corp., 453 F.2d at 304.

The Seventh Circuit addressed a situation similar to this case in *National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982). A wholly-owned subsidiary issued debentures convertible into common stock of the parent corporation,

and some debenture holders chose to convert their debentures. As in this case, the parent corporation and its affiliated corporations filed a consolidated federal income tax return. The *parent* corporation effected the conversions and "treated the excess . . . of the market value of the [parent corporation's] common stock over the face amount of the debentures as a premium paid for the acquisition of the [subsidiary's] debentures." *Id.* at 1110. The parent corporation amortized that amount over the remaining life of the debentures, but the Internal Revenue Service disallowed the amortization deductions.

In considering the parent corporation's suit for recovery of the additional taxes paid, the Seventh Circuit held that the amount described above was not amortizable bond premium under 26 U.S.C. § 171, but rather was a premium attributable to the conversion feature. Section 171 distinguishes premium attributable to the costs of borrowing from that attributable to a conversion feature and the court discussed the "complementary" provisions of 26 U.S.C. § 249.[6]

> Section [249] again illustrates the line Congress has consistently drawn between bond premium attributable to the interest cost of borrowing and bond premium attributable to a conversion privilege. As Congress reasoned in passing Section 249, premium due to a conversion feature is "not analogous to an interest expense or deductible business expense, but rather is similar to an amount paid in a capital trans-

[6]As we discussed earlier and as the Seventh Circuit recognized, section 249 prohibits a deduction to the *issuer* of the debentures. *See* 26 U.S.C. § 249; 687 F.2d at 1115 n.5. In *National Can*, the parent corporation effected the conversions of debentures issued by its subsidiary into the parent's common stock. Thus, *National Can* involved a non-issuer claiming the deduction. The instant case, however, fits squarely within the terms of section 249 since the issuer (CLEO) claimed the deduction.

> action. In effect, the corporation is repurchasing the right to convert the bonds into its common stock, much as it might purchase its stock." H.R.Rep. No. 413, 91st Cong, 1st Sess. 111, reprinted in 1969 U.S. Code Cong. & Ad. News 1645, 1759-1760; see also *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 306 n.19 (2d Cir. 1971). Here [the parent corporation's] transaction did not merely remove from the market the right to enter into a future capital transaction—the evil for which Section 249 disallows any deduction—but involved a present substitution of capital-stock liability for its subsidiary's bonded indebtedness. See Cary, *supra*, 74 Harv.L.Rev. at 497. Thus the Congressional purpose of disallowing deductions for premiums attributable to essentially capital transactions encompasses the transactions here.

687 F.2d at 1115-16.

As in *National Can*, the premium claimed by CLEO as a deductible loss is attributable to the conversion feature of the bonds. In effect, CLEO repurchased the right to convert the bonds into stock. Thus, we find that the five elements required by section 249's disallowance provisions are present in the instant case. The district court correctly held that section 249 applies to the transactions and bars the deduction claimed by CLEO.

B. *Effective Date Provision*

Appellant claims that section 249 does not apply to the instant conversion transactions because of the effective date provision of the statute. Appellant argues that CLEO was subject to a binding obligation to repurchase the debentures prior to April 22, 1969 and thus falls within the exception language of the statute. We disagree.

The effective date provision of section 249 was set forth in section 414(c) of the Tax Reform Act of 1969, Pub. L.

No. 91-172, 83 Stat. 487. That provision, as restated in the Code of Federal Regulations, provides, in relevant part:

> Under section 414(c) of the Tax Reform Act of 1969, the provisions of section 249 and this section shall apply to any repurchase of a convertible obligation occurring after April 22, 1969, *other than a convertible obligation repurchased pursuant to a binding obligation incurred on or before April 22, 1969,* to repurchase such convertible obligation at a specified call premium.

26 C.F.R § 1.249-1(f)(1) (emphasis added).

CLEO issued the debentures on March 1, 1966. Clark was obligated to convert the debentures, but "on or after 1 September 1970, CLEO could, at its option, redeem the debentures." Stipulation ¶ 7. The amendment to the indenture providing for CLEO to effect the conversions rather than Clark became effective on July 14, 1971. *See id.* at ¶ 12. CLEO did not incur a binding obligation to convert the debentures until 1971, well after the effective date of section 249. Thus, the district court correctly held that section 249 applied to CLEO when considering the effective date provision.

III.

For the reasons stated, we **AFFIRM** the judgment order of the district court.

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MICHIGAN

CLARK EQUIPMENT COMPANY and
CONSOLIDATED SUBSIDIARIES,

Plaintiff,

v File No. K87-266 CA8

UNITED STATES OF AMERICA,

Defendant.

_____/

OPINION

This case is before the Court on bench trial briefs of the parties and an agreed stipulation of facts. *See* Stipulation, No. K87-266 (Sept. 29, 1988). Plaintiff Clark Equipment Company and its consolidated subsidiaries bring this claim under 28 U.S.C. § 1346(a)(1) for the recovery of Internal Revenue taxes and interest, erroneously or illegally assessed or collected from plaintiffs. Plaintiffs seek judgement entered in their favor for $188,634, together with interest as provided by law for excessive taxes paid to defendant United States. By order of October 4, 1988, this Court relieved the parties from preparing a pretrial order and stated that following submission of trial briefs, the Court would consider the matter ready for decision.

Background

In 1966, Clark Equipment Company ("Clark") established a wholly-owned subsidiary, Clark Equipment Overseas Finance Corporation ("CLEO"). Stipulation, ¶ 2. In 1966, CLEO issued fifteen million dollars of debentures in $1,000 denominations. Stipulation, ¶ 5. The debentures had a stated annual interest of four and one-half (4-1/2%) percent, were guaranteed by Clark, and were convertible — at the option of the debenture holder — into Clark stock at an exchange rate of $78 of principal amount per share. This subsequently became $39 of principal amount per share after a two for one stock split. Stipulation, ¶ 8. Initially, Clark was obligated to effect the conversions. In 1971, pursuant to the terms of the debentures and the underlying trust indenture, the obligation to effect conversions of debentures into Clark stock was transferred from Clark to

CLEO. Stipulation, ¶ 12. After the 1971 transfer of the obligation to convert to CLEO, Clark agreed to keep reserved at all times the full number of shares of Clark stock deliverable upon the conversion of all outstanding debentures not theretofore converted and also guaranteed the due and punctual performance by CLEO of the obligation to convert. Indenture, Exhibit C, at § 11.01(a).

During 1973, the holders of debentures with an aggregate face value of $1,447,000 exercised their options to convert their debentures at a rate of $39 of principal amount per share of Clark stock. In exchange, CLEO provided the debenture holders with Clark stock (and cash in lieu of fractional shares) with an aggregate fair market value, as of the various dates of conversion, of $1,839,989.

Discussion

Issue

The issue presented in this case is whether CLEO is entitled to a tax deduction for the $392,989 difference between the $1,839,989 value of the stock and cash it exchanged for debentures with a principal amount of $1,447,000. There are a number of sub-issues raised as well, *i.e.*,

1) Is loss realized at the time of conversion of a debenture a "premuim paid or incurred" within the language and context of 26 U.S.C.§ 249?

2) Is a conversion of a debenture a "repurchase" of the debenture within the language and context of 26 U.S.C. § 249?

3) Were the 1973 losses incurred by CLEO repurchases pursuant to binding obligations incurred on or before April 22, 1969 within the context of the effective date provisions of Section 414(c) of the Tax Reform Act of 1969?

To begin with, defendant United States argues that CLEO is not entitled to the deduction it claims because the deduction is prohibited by Section 249 of the Internal Revenue Code of 1954, 26 U.S.C. § 249. Plaintiffs claim that a loss incurred on a conversion is not a deduction for a premium paid.

Law

Section 249 of Title 26 reads as follows:

Sec. 249. Limitation on Deduction of Bond Premium on Repurchase

(a)*General Rule*. —No deduction shall be allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note, or certificate or other evidence of indebtedness which is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness which are not convertible. The preceding sentence shall not apply to the extent that the corporation can demonstrate to the satisfaction of the Secretary or his delegate that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature.

(b)*Special Rules*. —For purposes of subsection (a) —

(1)*Adjusted issue price*. —The adjusted issue price is the issue price (as defined in section 1232(b)) increased by any amount of discount deducted before repurchase, or, in the case of bonds or other evidences of indebtedness issued after February 28, 1913, decreased by any amount of premium included in gross income before repurchase by the issuing corporation.

(2)*Control*. —The term "control" has the meaning assigned to such term by Section 368 (c).

26 U.S.C. § 249 (in 1973).

The effective date provision, contained in Section 414(c) of the Tax Reform Act of 1969, and restated in Treasury Regulations on Income Tax, 26 C.F.R. § 1.249-1, states, in pertinent part, as follows:

> ...the provisions of [Code] section 249 and [section 1.249.1 of the regulations] shall apply to any repurchase of a convertible obligation occurring after April 22, 1969, other than a convertible obligation repurchased pursuant to a binding obligation incurred on or before April 22, 1969, to repurchase such convertible obligation at a specified call premium.

Neither Section 249 nor the related regulations define "premium paid." There is likewise no mention of "loss" or "loss upon conversion" in Section 249 or its regulations. In general, principles of statutory construction suggest that taxing acts are not to be extended by implication beyond the clear impact of the language. *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 93-94 (1934). It is also true that, in general, doubts are to be resolved in favor of the taxpayer and against the government. *Id.*

Although the case law is sparse on this issue, the facts in this case are similar to the facts in *National Can Corporation v. United States*, 687 F.2d 1107 (7th Cir. 1982), where the court denied deductions claimed by the corporate taxpayer for the excess of the fair market value of the taxpayer's stock exchanged by the taxpayer to effect the conversion of convertible debentures. In *National Can*, the parent corporation effected the conversions, exchanging its own stock for the convertible debentures issued by its subsidiary. Here, of course, the subsidiary exchanged its parent's stock for the convertible debentures issued by the subsidiary.

The Seventh Circuit looked carefully at §249 of the Code in the process of deciding one of the issues on appeal. The court concluded that "[The parent corporation] does not come strictly within the provisions of Section 249, since it was not the issuing corporation of [the subsidiary's] debentures." 687 F.2d at 1115 & n.5. In spite of the fact that §249 did not technically aply, the court used the rationale behind the statue to decide the issue before it.

The court reasoned that the Congressional purpose behind §249 was to disallow corporate taxpayers deductions for

premiums attibutable to essentially capital transactions. *Id.* at 1115-16. It wrote:

> [Section 249] again illustrates the line Congress has consistently drawn between bond premiums attributable to the interest cost of borrowing and bond premium attributable to a conversion privilege. As Congress reasoned in passing Section 249, premium due to a conversion feature is 'not analogous to an interest expense, but rather is similar to an amount paid in a capital transaction.'

Id. at 1115. The "evil" for which §249 disallows a business expense deduction is, according to *National Can*, the right to enter into a future capital transaction. *Id.* The court called the exchange of stock in *National Can* "a present substitution of capital stock liability for...bonded indebtedness" or, put another way, "essentially [a] capital transaction." *Id.* at 1115-16.

The relevamt exchange in this case too is essentially a capital transaction. Under *National Can* and the language of §249 which prevents a deduction for a repurchase price that is in excess of "a normal call premium on bonds or other evidences of indebtedness which are not convertible," I believe that §249 applies to the case before me. This type of loss upon conversion seems to be precisely the type of premium paid envisioned by Congress when they enacted §249.

As to the second subissue, I do not think much elaboration is necessary. The word "repurchase" is used broadly to cover the rendering of money or, as is a common method of disposal, the conversion of the bond or debenture into stock.

Plaintiffs here also dispute whether §249 is properly applied to the transaction here because of §249's effective date. That effective date provision, contained in Section 414(c) of the Tax Reform Act of 1969, and restated in Treasury Regulations on Income Tax, 26 C.F.R. §1.249-1, states, in pertinent part, as follows:

> ...the provisions of [Code] section 249 and [section 1.249-1 of the regulations] shall apply to any repurchase of a convertible obligation occurring after April

> 22, 1969, *other than a convertible obligation repurchased pursuant to a binding obligation incurred on or before April 22, 1969, to repurchase such convertible obligation at a specified call premium.*

Id. (emphasis added)

While the debentures in question were issued before April 22, 1969, the binding obligation was not the obligation of the taxpayer here, the party attempting to claim the binding obligation as an exception to this regulation. I agree that Clark Equipment had a binding obligation prior to April 22, 1969 to effect the conversions; however, it is equally true that CLEO had no such obligation until 1971 when the obligation was transferred from Clark Equipment to CLEO. *See* Stipulation, ¶ 12. Treasury Regulation §1.249-1 refers directly to Section 249 which denies a deduction to" *the issuing corporation* for any premium paid or incurred upon the *repurchase* of a...convertible debenture..." 26 U.S.C. §249. Thus regulation §1.249-1 impliedly refers to the obligation of the one claiming the tax deduction and issuing the debentures. Moreover, the exception for a binding obligation incurred on or before April 22, 1969 is not just any obligation associated with the debentures, but is it a binding obligation "to repurchase such convertible obligation at a specified call premium." Before 1971, this obligation was Clark Equipment's; after 1971, the obligation was CLEO's.

APPENDIX

Year[1]	Fair Market Value of Clark Shares and Cash Provided for Debentures	Face Amount of Debentures Converted	Excess of FairMarket Value of Stock and Cash Over Face Amount of Debentures
1973	$1.839,989	$1,447,000	$392,989

[1]Tax and Calendar Year

Therefore, in sum, I hold that CLEO is not entitled to a tax deduction for the $393,989 difference between the $1,839,989 value of the stock and cash it exchanged for debentures with a principal amount of $1,447,000, because the loss realized at the time of conversion of those debentures is subject to the provisions of Section 249 of the Code.

RICHARD A ENSLEN

U.S. District Judge

DATED in Kalamazoo, MI:
July 14,1989

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MICHIGAN

CLARK EQUIPMENT COMPANY and
CONSOLIDATED SUBSIDIARIES,

Plaintif,

v File No. K87-266 CA8

UNITED STATES OF AMERICA,

Defendant

_____ /

JUDGEMENT ORDER

In accordance with the opinion entered on this date;

IT IS HEREBY ORDERED that CLEO is not entitled to a tax deduction for the $393,989 difference between the $1,839,989 value of the stock and cash it exchanged for debentures with a principal amount of $1,447,000 because the loss realized at the time of conversion of those debentures is subject to the provisions of Section 249 of the Code.

RICHARD A. ENSLEN

U.S. District Judge

DATED in Kalamazoo, MI:
July 14, 1989

26 U.S.C. § 249

SEC. 249. LIMITATION ON DEDUCTION OF BOND PREMIUM ON REPURCHASE

(a) GENERAL RULE. —No deduction shall be allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note, or certificate or other evidence of indebtedness which is convertible into the stock of the issuing corporation, or a corporation in control of or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness which are not convertible. The preceding sentence shall not apply to the extent that the corporation can demonstrate to the satisfaction of the Secretary that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature.

(b) SPECIAL RULES. —For purposes of subsection (a) —

(1) ADJUSTED ISSUE PRICE. —The adjusted issue price is the issue price (as defined in sections 1273(b) and 1274) increased by any amount of discount deducted before repurchase, or, in the case of bonds or other evidences of indebtedness issued after February 28, 1913, decreased by any amount of premium included in gross income before repurchase by the issuing corporation.

(2) CONTROL. —The term "control" has the meaning assigned to such term by section 368(c).